

# HARVEY M. ROSE ASSOCIATES, LLC

1390 Market Street, Suite 1025 • San Francisco, California 94102  
(415) 552-9292 • (415) 252-0461 (FAX) • [www.harveyrose.com](http://www.harveyrose.com)

public sector management consulting



October 23, 2007

**To:** Mayor Chuck Reed  
Mayor's Budget Shortfall Advisory Group

**From:** Roger Mialocq *RM*  
Harvey M. Rose Associates, LLC

**Subject: Prepayment of Annual Employer Retirement Contributions**

The City's annual cost of its employer contribution to the Police and Fire and Federated Employees' Retirement Systems amounts to approximately \$136.0 million for FY 2007-08. The General Fund portion of this cost amounts to \$102.4 million and the non-General Fund cost totals approximately \$33.7 million. The City pays these costs bi-weekly through the payroll system. If the City were to prepay this annual cost with a single lump sum payment on approximately July 14 of each fiscal year, the total annual employer contribution requirement would be reduced by approximately \$5,171,529, since the retirement systems would have use of the full annual amount for the entire fiscal year in order to generate investment income, versus approximately one-half of the annual amount for the fiscal year.

Offsetting Loss of Investment Income

If the City were to implement a prepayment strategy, it would forego the investment income on the portion of the annual payment that would have been invested on a short-term basis during the fiscal year. However, based on the City's current average investment yield of 4.66 percent as of August 2007, lost investment income would amount to only about \$3,156,863 annually, resulting in a net benefit to the City of approximately \$2,014,666 annually (Attachment 1). As the short-term investment yield of the City increases in times of higher short-term interest rates the net benefit to the City would be reduced, and in times of lower short-term interest rates the net benefit would increase. As an example, based on a short-term yield of 5.00 percent, the annual net benefit would be about \$1,783,610. Based on a short-term yield of 5.25 percent, the annual net benefit would be about \$1,614,214. The net benefit of prepayment of employer retirement contributions would be distributed between the General Fund and other funds in proportion to the amount of each fund's annual contribution to



the retirement systems. Based on the City's current short-term investment yield of 4.66 percent, the annual net benefit to the General Fund if the City had prepaid its FY 2007-08 employer retirement contribution would have been approximately \$1,477,993.

#### Analysis of the City's Average Daily Cash Balances

According to the latest investment report to the Mayor and the City Council, dated October 2, 2007, during the past 24 months the City's cash position has ranged from a low of about \$340 million to a high of about \$415 million. The General Fund portion of the cash balance ranged from a low of about \$145 million to a high of about \$315 million. Consequently, it appears that the City could prepay most if not all of this annual cost, and realize a net benefit in proportion to the extent of the prepayment.

#### Additional Reduction of the Employer Contribution Rates

The FY 2007-08 employer contribution rates amount to 25.22 percent for the Police and Fire Retirement System, and 21.98 percent for the Federated Employees Retirement System. While the benefits of prepayment described above are substantial, they are not the complete benefit that would be realized by the City. The prepayment benefits were calculated based on the difference between the assumed rate of return of the two retirement systems (8.00 percent and 8.25 percent) and the average annual investment yield currently being realized by the City of 4.66 percent. However, an analysis of the actual rate of return earned by the two retirement systems over the past 20 fiscal years, determined that the actual average rates of return amounted to 10.31 percent for the Police and Fire Retirement System and 9.60 percent for the Federated Employees Retirement System (Attachment 2). Consequently, prepayment of the annual employer contribution would enable the retirement systems to earn an additional \$1,034,996 annually. These additional earnings would increase plan assets and funding levels, and further reduce the amount of the required annual employer contribution rates as each biennial actuarial valuation is performed.

#### Retirement Systems Assumed Rate of Return on Investments

As noted above, the Police and Fire Employees' Retirement System currently has an assumed rate of return on investments of 8.00 percent, while the Federated Employees' Retirement System has an assumed rate of 8.25 percent. Attachment 2 provides an historical comparison of the actual rate of return of both systems over the past 20 years. During that period, the Federated Employees' Retirement System realized an average rate of return of 9.60 percent, or 16.4 percent greater than its 8.25 percent assumed rate of return. Comparatively, the Police and Fire Employees' Retirement System realized an average rate of return of 10.31 percent, or 28.9 percent greater than its 8.00 percent assumed rate of return.

Because the Police and Fire Employees' Retirement System is 100 percent funded by the General Fund, and due to the large amount of the total retirement system



liability, which amounted to \$2.027 billion as of June 30, 2005, minor changes in the assumed rate of return on investment have a significant impact on the amount of the annual employer contribution. Currently, based on the 8.00 percent assumed rate of return on investment, the FY 2007-08 employer contribution requirement to the Police and Fire Employees' Retirement System amounts to \$62,284,000. If the Police and Fire Employees' Retirement System were to adopt the same 8.25 percent assumed rate of return as the Federated Employees' Retirement System, it is projected that the City's annual employer contribution requirement would be reduced by about \$2,750,000. Based on an assumed rate of 8.25 percent, the 10.31 percent actual average annual rate of return of the Police and Fire Employees' Retirement System would exceed the assumed rate by 25.0 percent.

Based on a 2005 survey of 30 of the largest state, county and city retirement systems in the United States, the mean rate was 8.07 percent with 10 systems between 8.16 percent and 9.00 percent, 14 systems at 8.00 percent, and six systems between 7.90 percent and 7.00 percent. If there is interest in this issue, a request should be submitted to the City's retirement system actuary to calculate the impact on the City's annual employer contribution requirement, if the Police and Fire Employees' Retirement System changed its assumed rate of return to 8.25 percent.



# Analysis of City of San Jose Retirement System Prepayment Savings

(Based on the City's Current Average Yield of 4.66 Percent for August 2007)

Description	FY 2007-08 Budget	Bi-weekly Payment	Ret Sys Prepayment Not Avail for Investment	Lost Com Fund Interest	Date
Ret Sys Police & Fire Discount	3.6848%	5,033,480	0	0	07/01/07
Ret Sys Federated Discount	3.8999%	5,033,480	130,870,471	234,510	07/15/07
Ret Sys Police & Fire Normal Employer Contribution	62,284,000	5,033,480	125,836,991	225,490	07/29/07
Ret Sys Federated Normal Employer Contribution	73,758,000	5,033,480	120,803,512	216,471	08/12/07
Ret Sys Police & Fire Reduced Employer Contribution	59,988,959	5,033,480	115,770,032	207,451	08/26/07
Ret Sys Federated Reduced Employer Contribution	70,881,512	5,033,480	110,736,552	198,431	09/09/07
Employer Contribution Savings	5,171,529	5,033,480	105,703,073	189,412	09/23/07
Less Lost Commingled Fund Interest Revenue	-3,156,863	5,033,480	100,669,593	180,392	10/07/07
<b>Net FY 2007-08 Budget Savings</b>	<b>2,014,666</b>				
San Jose Investment Portfolio FY 2007-08 Projected Interest Rates:					
	Rate				
Jul-Sep	4.66%	5,033,480	15,100,439	27,059	06/01/08
Oct-Dec	4.66%	5,033,480	10,066,959	18,039	06/15/08
Jan-Mar	4.66%				
Apr-Jun	4.66%				
		<b>130,870,471</b>		<b>3,156,863</b>	

Note:

In addition to the annual budget savings of approximately \$2,014,666, the retirement system would earn additional investment income estimated to amount to about \$1,034,996 annually, based on the difference between the assumed rates of 8.00% police and fire and 8.25% federated, versus the actual average annual rates of return over the past 10 years of 10.31% and 9.60% respectively.



**City of San Jose Retirement Systems**  
**Comparison of Actual Investment Results**  
**FY 1986-87 to FY 2005-06**

**Attachment 2**

	<b>Pol &amp; Fire</b>	<b>Federated</b>
FY 2005-06	14.30%	10.81%
FY 2004-05	11.00%	8.91%
FY 2003-04	16.50%	16.62%
FY 2002-03	5.40%	6.85%
FY 2001-02	-1.30%	-1.68%
FY 2000-01	2.00%	-0.16%
FY 1999-00	8.00%	7.60%
FY 1998-99	11.20%	10.57%
FY 1997-98	16.70%	16.50%
FY 1996-97	16.00%	15.50%
FY 1995-96	14.70%	13.00%
FY 1994-95	16.70%	15.60%
FY 1993-94	1.30%	0.00%
FY 1992-93	14.10%	12.60%
FY 1991-92	13.60%	12.50%
FY 1990-91	8.40%	8.70%
FY 1989-90	9.70%	10.00%
FY 1988-89	14.10%	13.90%
FY 1987-88	3.50%	3.80%
FY 1986-87	10.20%	10.40%
<b>Average</b>	<b>10.31%</b>	<b>9.60%</b>